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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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JAN 11 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

AT&T Communications)
Tariff F.C.C. Nos. 1 and 13)
Transmittal Nos. 7322 and 7848)

Bell Atlantic Telephone Companies)
Tariff F.C.C. No. 1)
Transmittal Nos. 704 and 747)

CC Docket No. 94-139

DIRECT CASE OF AT&T CORP.

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SUMMARY

The Commission's continued examination of these accounting issues as to AT&T is foremost an unnecessary expenditure of regulatory resources. Based on the overwhelming evidence that the interexchange market is now vigorously competitive, the Commission recently reclassified AT&T as a nondominant carrier in the interstate domestic interexchange market in order to free AT&T from the burdensome constraints of price cap regulation for all services in that market. This action underscores that the price cap issues under investigation are not matters of ongoing importance. So long as AT&T's exogenous adjustment for SFAS 112 is reasonable -- as it unquestionably is -- the Commission should move on to consideration of more compelling matters.

In Section I, AT&T demonstrates that its calculation of SFAS 112 postemployment benefit costs eligible for exogenous price cap treatment -- the transition amount as of the January 1, 1994 mandatory effective date for SFAS 112 adoption -- was based on AT&T employee demographic census data and sound actuarial assumptions, and the subsequent regulatory separations and allocation processes were handled in accordance with Commission requirements. As the Direct Case shows in detail, the actuarial assumptions used in sizing the AT&T SFAS 112 accrual were, by any measure, reasonable. Indeed, the actuarial assumptions underlying AT&T's calculations are

identical to those used for external financial reporting purposes. The SFAS 112 expenses for financial reporting purposes were endorsed by AT&T's independent auditors, Coopers & Lybrand, and passed a "peer review" performed by an independent actuarial firm. Finally, AT&T had the independent obligation to be reasonable as to the SFAS 112 expense it booked for financial reporting purposes, because the expense constituted a charge against the firm's earnings as reported to shareholders.

Additionally, Section I shows that the percentage of the total AT&T Corp. SFAS 112 expense attributed to AT&T Communications achieved a reasonable, cost-causative allocation, based on relevant headcount. AT&T then applied jurisdictional separations factors to identify the interstate portion of the SFAS 112 expense. AT&T allocated the interstate SFAS 112 costs between capped and noncapped services and among AT&T's price cap baskets on a cost-causative basis. In short, AT&T's SFAS 112 exogenous cost amounts are based on reasoned actuarial standards as to their calculation, and the subsequent regulatory separations and allocations processes are justified.

In Section II, AT&T demonstrates that no adjustment to the exogenous amount claimed for the SFAS 112 transition amount need be made to avoid a "double count," because SFAS 112 costs are not reflected in the inflation component of the price cap formula, for two independent reasons. Most notably, SFAS 112 costs are accounting

changes only; they are not economic costs. Moreover, the SFAS 112 transition amount is, in any case, a "sunk" cost that would not be reflected in competitive firms' pricing decisions. Because the GDP-PI reflects only economic changes that are included in pricing decisions, SFAS 112-related costs are not accounted for in that index, and thus exogenous treatment will not result in double recovery. AT&T's SFAS 112 exogenous adjustment is highly conservative because, notwithstanding these facts, it includes a 10.14% double count offset, which reduced the exogenous amount by \$42 million.

Section III shows that exogenous treatment should not be limited to those SFAS 112 costs that a carrier has "funded" or to benefits in which employee interests have "vested." Neither GAAP, regulatory accounting rules nor price cap regulation requires that a carrier prefund its SFAS 112 costs or that it accrue such expenses only for employees that have vested interests in postemployment benefits. To the contrary, SFAS 112 expressly requires employers to accrue their postemployment expenses irrespective of funding or vesting status. In these circumstances, imposing either a "prefunding" or "vesting" requirement for exogenous treatment is foreclosed by the Court of Appeals' ruling in a related context (SFAS 106) that the Commission may not deny exogenous treatment for costs created by a shift to accrual accounting simply because the carrier could "control" the underlying benefit

expense (for example, by failing to set aside funds or modifying benefit provisions for nonvested employees).

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CC Docket No. 94-139

DIRECT CASE OF AT&T CORP.

Pursuant to the Order Designating Issues for Investigation, DA 95-2407, released November 30, 1995 ("Designation Order"), AT&T Corp. ("AT&T") submits this response to the Common Carrier Bureau's questions relating to AT&T's inclusion of postemployment benefits as exogenous cost adjustments to its price cap indices ("PCIs") based on mandatory adoption of Statement of Financial Accounting Standards No. 112 ("SFAS 112").

The Direct Case that follows first reviews the relevant accounting and legal precedents governing the Commission's investigation of this issue. In Section I, AT&T demonstrates that its calculation of the amount of SFAS 112 costs eligible for exogenous price cap treatment was reasonable. Section II demonstrates that no adjustment to the SFAS 112 transition amount would need to be made to avoid a double count, because SFAS 112 costs are not

reflected in the inflation component of the price cap formula. (Indeed, AT&T's SFAS 112 exogenous amount is highly conservative because it nonetheless includes a 10.14% double count offset). Section III shows that the Court of Appeals' ruling that the Commission may not deny exogenous treatment for analogous SFAS 106 post-retirement benefits other than pensions ("OPEB") costs, simply because the carrier could "control" the underlying benefit expense, similarly forecloses limiting exogenous treatment to "prefunded" or "vested" SFAS 112 amounts.¹

Although this Direct Case responds fully to the detailed factual and policy questions raised in this investigation, it is also apparent that the Commission's continued examination of these types of issues as to AT&T -- alone among interexchange carriers ("IXCs") -- is unwarranted and superfluous. The Commission's recent reclassification of AT&T as a nondominant carrier in the domestic interstate interexchange market reflects that that market is now fully competitive and that AT&T must be allowed to compete on an equal footing with its

¹ Appendix A contains detailed responses to each of the Commission's enumerated issues to the extent that they are not fully addressed in the text of the pleading. Appendices B through H provide further support for AT&T's responses to the investigation issues.

interexchange competitors.² This investigation starkly confirms the harms -- to AT&T, to competition, and to the public interest -- that increasingly flow from the Commission's misapplication to AT&T of rules that long have lost any rationale or basis. Here, the Commission is considering action that could require AT&T (but no other IXC) to change its prices based solely on a second-guessing of old accounting assumptions, and totally without regard to the competitive forces that truly govern the interexchange market.

Moreover, the Commission's prospective elimination of exogenous treatment for accounting changes that do not

² See Motion of AT&T Corp. to be Treated as a Nondominant Carrier, Order, FCC 95-427, released October 23, 1995 ("AT&T Nondominance Order"). AT&T's filings furthermore demonstrate that all interexchange markets, including international message services, are fully competitive. See Motion for Reclassification of American Telephone and Telegraph Company as a Nondominant Carrier, CC Docket No. 79-252, filed September 22, 1993; Reply Comments of AT&T, CC Docket No. 79-252, filed December 3, 1993; Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier, CC Docket No. 79-252, filed April 24, 1995 (updating evidence submitted in 1993); additional Ex Partes in id., filed June 12, 1995 and November 8, 1995; Reply Comments of AT&T, CC Docket No. 79-252, filed June 30, 1995. See also AT&T's Comments, filed July 3, 1995, and AT&T's Reply Comments, filed July 24, 1995, Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, and Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197. See also FCC Public Notice, "Pleading Cycle Established for Comments on AT&T's Motion for Reclassification as a Non-Dominant Carrier for International Services," CC Docket No. 79-252, DA 95-2366, released November 21, 1995.

result in economic cost changes (such as for postemployment benefits) further confirms that the issues under investigation are not matters of ongoing importance.³ Thus, particularly given that AT&T's SFAS 112 exogenous adjustment is reasonable -- as this Direct Case unquestionably shows -- the Commission should move on to consideration of more compelling matters.

BACKGROUND STATEMENT

Based on a change in generally accepted accounting principles ("GAAP") implemented in SFAS 112 and adopted by the Commission, all carriers were required to change their method of accounting for postemployment benefits (such as the severance benefits and disability-related benefits provided to former or inactive employees) from a cash to an

³ The Commission has already changed the local exchange carrier ("LEC") price cap rules relating to exogenous treatment of accounting standards changes and has similarly proposed changing the AT&T price cap rules. See Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd. 8961 (¶¶ 292-320) (1995) ("LEC Price Cap Performance Review Order"); see also Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Further Notice of Proposed Rulemaking, FCC 95-198, released May 18, 1995, ¶¶ 68-70. Assuming that there were any further need to continue price cap regulation of AT&T's Basket 1 international message services (which there is not), AT&T does not oppose the Commission's proposal. See AT&T's Comments, filed July 3, 1995, CC Docket Nos. 87-313 and 93-197, p. 3 n.4.

accrual basis no later than January 1, 1994.⁴ Prior to SFAS 112, companies generally accounted for postemployment benefits on a cash or "pay-as-you-go" basis, recognizing the benefit amounts actually paid in the current accounting period. SFAS 112 required companies to account for ongoing postemployment benefits on an accrual basis, in effect treating them as a form of deferred compensation earned by

⁴ Statement of Financial Accounting Standards No. 112, "Employers' Accounting for Postemployment Benefits" (Financial Accounting Standards Board, Financial Accounting Series No. 121-C, November 1992), ¶ 3 ("SFAS 112"); Responsible Accounting Officer Letter 22, 8 FCC Rcd. 4111 (1993) ("RAO Letter 22"); Designation Order, ¶¶ 2-3.

SFAS 112 (¶ 6) requires that postemployment benefits be accounted for in accordance with SFAS 43, Accounting for Compensated Absences, and under SFAS 5, Accounting for Contingencies, if all four SFAS 43 criteria are not met. Specifically, SFAS 43 states that an employer shall accrue a liability for employees' compensation if the following conditions are met: (1) employees' right to receive compensation is attributable to employees' services already rendered; (2) the obligation relates to rights that vest or accumulate; (3) the payment is probable; and (4) the amount can be reasonably estimated. As required by SFAS 112, AT&T accounted for its Postemployment Separation Benefits in accordance with SFAS 43, because severance benefits meet all four enumerated criteria. As to the second factor, although severance benefits do not "vest," they do accumulate with an employee's years of service.

In accordance with SFAS 112, AT&T accounted for its Long Term Disability-Income Replacement and Long Term Disability-Medical benefits in accordance with SFAS 5, which indicates that an accrual should be made if it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. AT&T did not account for Long Term Disability Benefits under SFAS 43, because these benefits do not meet the second factor of the SFAS 43 test. See Appendix E, Response to Issue No. 42.

employees during their active, working years.⁵ SFAS 112 additionally required companies to recognize on their books the amounts of their unfunded SFAS 112 obligation as of SFAS 112 adoption. This unfunded obligation, referred to as the "transition amount," reflects the amount a company would have accrued on its books as of SFAS 112 adoption, if it had been employing accrual accounting all along. In accordance with SFAS 112, the Common Carrier Bureau allowed carriers to recognize the transition amount on a flash-cut basis as an immediate expense.⁶

After the Common Carrier Bureau required carriers to conform their regulatory accounting practices to SFAS 112,⁷ AT&T in 1994 filed for exogenous price cap treatment for the change in postemployment benefit costs resulting from SFAS 112 implementation.⁸ Under price caps,

⁵ Designation Order, ¶ 5.

⁶ RAO Letter 22; G. Michael Crumling, 8 FCC Rcd. 2961 (1993).

⁷ Regulatory financial reporting includes, e.g., book entry into the Part 32 Uniform System of Accounts ("USOA"); expense recognition on the regulated income statement; Form M; ARMIS and Form 492 rate-of-return reports for LECs, and 87-503 quarterly reports for AT&T.

⁸ See AT&T Communications Tariff F.C.C. No. 1, Transmittal No. 7322, CC Docket No. 94-139, Memorandum Opinion and Order Suspending Rates, 9 FCC Rcd. 7228 (1994) ("SFAS 112 Suspension Order"); AT&T Communications Tariff F.C.C. Nos. 1 and 13, Transmittal No. 7848, CC Docket No. 94-139, Memorandum Opinion and Order, 10 FCC Rcd. 899 (1994).

a carrier may raise its PCIs to reflect an "exogenous" cost to the extent that those costs: "are triggered by administrative, legislative, or judicial actions that are beyond the control of the carriers and that are not already reflected in the price cap formula."⁹ The Bureau's disposition of AT&T's SFAS 112 filing was influenced by how the Commission had previously elected to treat SFAS 106 OPEB costs for purposes of exogenous treatment.¹⁰

In 1993, in response to LEC requests for exogenous treatment of costs associated with a similar change to accrual accounting for OPEBs under SFAS 106, the Commission had adopted an order denying exogenous treatment of those costs.¹¹ In July 1994, the U.S. Court of Appeals for the

⁹ Designation Order, ¶ 8, citing LEC Price Cap Order, 5 FCC Rcd. 6786, 6806-6809 (1990); AT&T Price Cap Order, 4 FCC Rcd. 2873, 3002-3021 (1989).

¹⁰ Designation Order, ¶ 10, citing SFAS 112 Suspension Order.

¹¹ Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers' Accounting for Postretirement Benefits Other Than Pensions", 8 FCC Rcd. 1024 (¶ 3) (1993) ("OPEB Order"); reversed and remanded sub nom. Southwestern Bell Telephone Company v. FCC, 28 F.3d 165 (D.C. Cir. 1994) ("DC Circuit OPEB Order"), vacating OPEB Order, Memorandum Opinion and Order, CC Docket No. 92-101, FCC 95-219, released July 3, 1995. Specifically, with respect to OPEB, the Commission had concluded that "ongoing OPEB costs" are not entitled to exogenous treatment because of the substantial control that LECs have over their ongoing health care benefit plans. See OPEB Order, ¶¶ 53-55. Furthermore, the Commission had denied exogenous treatment for the OPEB transition benefit obligation without determining whether the LECs could control this cost, because no LEC had shown that

District of Columbia Circuit reversed and remanded the Commission's OPEB Order that had denied exogenous treatment of OPEB costs, concluding that changes in a carrier's OPEB costs caused by the implementation of SFAS 106 are eligible for exogenous treatment.¹² Specifically, the Court concluded that the "control" prong of the test for exogenous treatment had been met because carriers were mandated by the Commission to adopt SFAS 106 and thus the accounting change was plainly outside of the carriers' control. Under the Commission's own prior explanations of "control," exogenous costs are "in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers."¹³ The Court thus held that it was impermissible for the Commission to deny exogenous treatment based on the fact that carriers could "control [the underlying expense, i.e.,] the present and future benefit plans they set with their employees and the costs of these

(footnote continued from previous page)

this cost was not already reflected in the price cap formula. Id., ¶¶ 59-60.

¹² DC Circuit OPEB Order, 28 F.3d at 169, 173.

¹³ Id., citing Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, 6807 (1990) ("LEC Price Cap Order"), modified on recon., 6 FCC Rcd. 2637 ("LEC Price Cap Reconsideration Order"), further recon. dism'd, 6 FCC Rcd. 7482 (1991).

plans."¹⁴ For the Commission to have done so, the Court held, essentially constituted a change in its price cap rules which could only be accomplished through another rulemaking.¹⁵

In the OPEB Order, the Commission had also rejected exogenous treatment for the OPEB transition benefit obligation (without addressing the control prong) because it concluded that the carriers had failed to show the absence of a "double count" under GNP-PI.¹⁶ The Court found, however, that the Commission had improperly rejected the carriers' studies estimating a double count without "express[ing] a reason for doubting some critical assumption."¹⁷ Similarly, the Court held that the fact that SFAS 106 required carriers to make numerous potentially highly speculative assumptions about the cost of future

¹⁴ DC Circuit OPEB Order, 28 F.3d at 169-70; citing OPEB Order, ¶ 53.

¹⁵ 28 F.3d at 169-70 (citations omitted).

¹⁶ OPEB Order, ¶¶ 57-66. The PCI or "price cap" includes three components: (1) an inflation measure (Gross National Product Price Index or "GNP-PI") which reflects economy-wide price changes, (2) a productivity offset to GNP-PI to reflect the historical productivity of carriers which has exceeded that of the economy generally, and (3) exogenous cost changes. LEC Price Cap Reconsideration Order, 6 FCC Rcd. 2637, 2667, n.77 (1991). More recently, the Commission has relied on the Gross Domestic Product Price Index ("GDP-PI") as an inflation measure for price cap purposes. LEC Price Cap Performance Review Order, ¶¶ 347-51.

¹⁷ 28 F.3d at 172.

benefits, could be a basis for rejection only if there was no way of obtaining conservative estimates.¹⁸

Finally, the Court found that the Commission had impermissibly invoked "several altogether new criteria" for rejecting the claims for exogenous treatment.¹⁹ As the Court held, "whatever the intrinsic merits of these three possible bases for rejecting exogenous cost treatment, the Commission is free to consider them as a basis for amending its current rules, not for concocting a new rule in the guise of applying the old."²⁰

Following the DC Circuit OPEB Order, the Bureau allowed AT&T's SFAS 112 tariff filing to take effect on November 30, 1994, subject to an accounting order and investigation. Although as the Designation Order (§ 10) recognizes, "GAAP changes, once mandated by the Commission . . . are entitled to automatic exogenous treatment," the Bureau is investigating "the proper amounts" of SFAS 112 costs eligible for such treatment.

¹⁸ Id., citing OPEB Order, ¶ 65.

¹⁹ 28 F.3d at 172-73. These new criteria included the Commission's theories as to: (1) intertemporal double count; (2) rate-of-return double count; and (3) productivity double count.

²⁰ 28 F.3d at 173 (emphasis in original).

I. AT&T'S CALCULATION OF THE AMOUNT OF SFAS 112 COSTS ELIGIBLE FOR EXOGENOUS PRICE CAP TREATMENT WAS REASONABLE.

AT&T filed for exogenous treatment of its SFAS 112 expenses on August 1, 1994, and the Bureau allowed the PCI changes to become effective on November 30, 1994.²¹ For that filing, AT&T computed the exogenous adjustment based solely on the transition amount valued as of January 1, 1994, the mandatory date for SFAS 112 adoption. AT&T's exogenous PCI amount was for a 12-month period from November 30, 1994 to November 30, 1995, and it did not include any ongoing SFAS 112 postemployment benefits costs.²² The

²¹ See AT&T Transmittal No. 7322, filed August 1, 1994, as amended by Letter, dated November 18, 1994, from M. F. DelCasino, AT&T Administrator - Rates and Tariffs, to W. F. Caton, Acting Secretary, FCC ("November 18, 1994 Letter"), Attachment 2. See also SFAS 112 Suspension Order.

²² As permitted by SFAS 112 and RAO Letter 22, on both its financial and regulated books, AT&T expensed the entire SFAS 112 transition liability effective January 1, 1993 for reporting purposes. However, contrary to the statement in the Designation Order (§ 19), AT&T sought exogenous price cap treatment for the SFAS 112 transition amount effective January 1, 1994, the mandatory adoption date for SFAS 112. The SFAS 112 transition amount that AT&T computed for exogenous treatment represents the present value (as of the January 1, 1994 calculation date) of future postemployment benefits that are expected to be paid to employees and eligible dependents, allocated to service rendered prior to January 1, 1994. Inclusion of accrued costs for all service rendered prior to January 1, 1994 is appropriate and is implicitly a part of the SFAS 112 transition amount valued as of that date. The exogenous cost impact of the SFAS 112 accounting change is that the excess of SFAS 112 accruals above the pay-as-you-go amount is eligible for exogenous cost treatment. See Appendix C.

resulting interstate cost increase as shown in AT&T's filing was approximately \$373 million, of which \$201.2 million was allocated to interstate capped services, with \$200.2 million of that amount allocated to Basket 1.²³

Effective December 1, 1995, AT&T revised its PCIs, by removing the SFAS 112 exogenous amount previously claimed because, in accordance with RAO Letter 22, it was a one-year exogenous cost adjustment which had expired.²⁴ As shown below, AT&T's calculation of the amount of SFAS 112 transition costs eligible for exogenous price cap treatment is both reasonable and appropriate, and thus fully qualifies for exogenous treatment.²⁵

The SFAS 112 exogenous transition amount represents the present value of unfunded postemployment benefits that are expected to be paid to employees and their

²³ November 18, 1994 Letter, Attachment 1.

²⁴ See Letter, dated December 1, 1995, from M. Peterson, AT&T Administrator - Rates and Tariffs, to W. F. Caton, Acting Secretary, FCC. In that filing, AT&T removed the portion of the original SFAS 112 exogenous cost adjustment associated with its international services remaining in Basket 1. By then, all domestic services had been removed from the price cap baskets, in accordance with the Commission's AT&T Nondominance Order, ¶ 164, and the Bureau's follow-on Memorandum Opinion and Order regarding Re-Initialization of Indexes, DA 95-2378, released November 22, 1995. See AT&T Transmittal No. 9336, filed November 27, 1995, displaying AT&T's new Basket 1 price cap indices.

²⁵ See Appendix C, for a numerical display of how AT&T determined its SFAS 112 exogenous amounts.

eligible dependents for services rendered by the employees prior to January 1, 1994. The postemployment benefits of AT&T covered by SFAS 112 include: Postemployment Separation Benefits, Long Term Disability-Income Replacement, and Long Term Disability-Medical Benefits.²⁶ To quantify the amount associated with AT&T's SFAS 112 exogenous cost filing, AT&T first had to calculate the total company (AT&T Corp.) transition amount which was determined to be approximately \$2.1 billion.²⁷

In determining the total AT&T transition amount, AT&T was required to rely on actuarial assumptions applied to the AT&T employee demographic census data (sex, date of birth, net credited service, pay), including separation from employment, rates of mortality, disability, as well as retirement, and pay growth, to determine for each future year the employees expected to remain active and those expected to leave the Company. AT&T also had to make an

²⁶ AT&T maintains a funded plan asset, specifically a Voluntary Employees' Beneficiary Association ("VEBA") trust, for Long Term Disability-Income Replacement Benefits. See Appendix A, Responses to Issue Nos. 18, 24-32.

²⁷ This amount represents AT&T Corp.'s year-end 1993 SFAS 112 liability. Specifically, the \$2.1 billion included a one-time pretax charge of \$1.809 billion, the unfunded SFAS 112 transition accrual as of the Company's adoption of SFAS 112 effective January 1, 1993 on its financial books, plus \$301 million, the accrual for January 1, 1993 through December 31, 1993 associated with SFAS 112 adoption. See Appendix A, Responses to Issue Nos. 9 and 13.

assumption as to a discount rate used to calculate the present value of the SFAS 112 transition amount.

Each of the assumptions employed by AT&T was reasonable. The demographic assumptions used by AT&T are almost exclusively based on Company experience, which enhances their reliability for predicting when employees are likely to leave the firm.²⁸ Moreover, the percentage of employees expected to retire or terminate each year with severance benefits (overall approximately 3% annually) was based on AT&T's average historical downsizing rates for the years 1988 through 1992.²⁹ AT&T's own actual historical experience is the most accurate indicator of AT&T's future rates of separation as utilized in the SFAS 112 calculation.³⁰

²⁸ See Appendix E. The size of the AT&T employee population also enhances the validity of assumptions that are based on Company data.

²⁹ See Appendix E, p. 2. AT&T did not include in the downsizing rates for 1988-92 the approximately 20,000 employees who left the Company with enhanced service pension benefits, which are accounted for under SFAS 87 and 88. Unlike for traditional downsizing, the primary incentive for these employees to leave AT&T was pension enhancement rather than severance pay.

³⁰ For Long Term Disability-Income Replacement and Long Term Disability-Medical benefits, the SFAS 112 transition amount is the present value of these future benefits for employees who were already disabled and receiving these long term disability benefits at the time of SFAS 112 adoption. In other words, the SFAS 112 transition amount does not assume that any additional employees will become disabled in the future. See Appendix E.

AT&T's 8.25% discount rate for measurement of its SFAS 112 obligation as of January 1, 1994 was based on an analysis of rates-of-return on high-quality, fixed-income investments available in December 1992 and is consistent with those returns given that, at that time, the yield on 30-year U.S. Treasury bonds varied between 7.36% to 7.56%, and the corresponding Moody's Aa bond yield varied between 8.17% to 8.36%.³¹ Moreover, a subsequent Spencer Company survey indicated that the average discount rate used by other large corporations for 1993 SFAS 106 calculations was 8.14%, which confirms the reasonableness of AT&T's SFAS 112 assumption.³²

All of the actuarial assumptions discussed above (withdrawal, death, disability, retirement, and pay growth) that AT&T used to calculate the SFAS 112 transition amount have a high degree of reliability for the additional reason

³¹ Because AT&T had adopted SFAS 112 effective January 1, 1993 on its financial books, the total AT&T Corp. SFAS 112 transition amount employed a discount rate appropriate for 1993 implementation. Although the SFAS 112 transition amount for exogenous cost purposes employed the same discount rate as had been used for 1993 SFAS 112 adoption on the financial books, this was conservative because the January 1, 1994 discount rate would have been 7.50%. Had AT&T used a 7.50% discount rate in computing the SFAS 112 exogenous adjustment as of January 1, 1994 (instead of the 8.25% actually employed), its SFAS 112 accrual would have been approximately \$120 million higher.

³² See "Reporting Under FAS 106: Survey of Companies' Annual Statements," Spencer's Research Reports on Employee Benefits, § 328.03.-1, September 23, 1994.

that they are identical to assumptions that AT&T used to determine pension expenses under SFAS 87, as well as post-retirement benefit expenses under SFAS 106. This consistency reinforces the appropriateness of the assumptions and AT&T's confidence in the assumptions, on which it also relies to fund its pension and other post-retirement benefit plans. Significantly, the actuarial assumptions underlying the SFAS 112 exogenous adjustment are the same as those used to calculate the SFAS 112 transition amount for financial reporting purposes. Moreover, the SFAS 112 expenses for financial reporting purposes were reviewed and endorsed by Coopers & Lybrand, AT&T's external auditors. In addition, they underwent and passed an actuarial "peer review" performed by an independent consulting actuarial firm. Finally, AT&T had the independent obligation to be reasonable as to the amount of SFAS 112 expenses it booked for financial reporting purposes, as the expense was reported to shareholders as a charge against the firm's earnings.

The size of AT&T's transition amount is conservative for the additional reason that it includes a 10.14% GDP-PI double count offset of \$42 million, notwithstanding the fact that, on reflection, accounting changes such as SFAS 112 are not reflected in that index.³³

³³ See Appendix C and Pleading Section II, infra.

Moreover, the Postemployment Separation Benefits that AT&T now provides to its employees are more generous than those utilized when the SFAS 112 transition amount was calculated for exogenous treatment purposes.³⁴

The second step of AT&T's procedure -- to identify the portion of the \$2.1 billion total AT&T transition amount attributable to AT&T Communications -- was designed to achieve a reasonable, cost-causative allocation. Specifically, AT&T determined, based on the relationship of AT&T Communications regulated headcount to total AT&T headcount, that the percentage of that amount attributable to regulated AT&T Communications is 27.3%. This allocation factor was developed by using the year-end regulated employment totals reflected in AT&T's Form M for the period ending December 31, 1993, to determine the amount of SFAS 112 costs attributable to regulated services. Use of 1993 year-end data is appropriate because it was the then most current available annual data and because it tracks the

³⁴ See Appendix A, Responses to Issue Nos. 2 and 50. For example, the severance pay schedules have been improved for both management and nonmanagement employees; the duration of medical coverage has doubled for management employees entitled to severance who have more than one year of service. Also, the definition of "eligible pay" has been broadened for management employees under the Long Term Disability-Income Replacement plan. And, outside of SFAS 112, a Transition Assistance Program allows each employee entitled to severance benefits up to \$10,000 for formal education/training, relocation, and new business start-up expenses.

time period on which the dollar value of SFAS 112 expenses were computed.³⁵ As a result, the AT&T Communications transition amount is \$576 million, which is 27.3% of the total SFAS 112 transition amount of \$2.1 billion.

This \$576 million total annual AT&T Communications exogenous cost amount was multiplied by an interstate separations factor of 81.49%, which yields an AT&T Communications total interstate SFAS 112 transition amount of \$469.5 million.³⁶ This total interstate AT&T

³⁵ The 1993 Form M, filed April 1, 1994 (page 21.5), Communications Services headcount of 84,278 (regulated) divided by total AT&T Corp. headcount of 308,700 for the same period yields an allocation of 27.3%. AT&T's Form M reflects only the regulated headcount associated with Communication Services. This is because the Form M Communication Services headcount of 84,278 (utilized to obtain the 27.3% allocation) excludes headcount associated with nonregulated activities. The 84,278 headcount represents approximately 93.8% of the total 1993 combined AT&T Communications and AT&T Information Systems organization headcount of 89,849. The regulated portion of 93.8% was determined based on regulated 1993 wages and salaries as a percentage of total 1993 wages and salaries paid to all (regulated and nonregulated) employees in the combined organization.

³⁶ The interstate separations factor of 81.49% was derived in accordance with applicable Commission procedures. The total AT&T Communications SFAS 112 accrual was booked into USOA Account 32.6728 (Other General and Administrative), in accordance with the Part 32 Rules and RAO Letter 22. As mandated by the Part 36.392 jurisdictional separations rule, the separations factor for the corporate operations expense in Account 32.6728 was derived based on the separations factors of the Big Three Expenses (Plant Specific Expense, Plant Non-Specific Expense and Customer Operations Expense). In particular, calendar year 1993 Big Three Expense data were utilized to determine the appropriate separations factor (81.49%). That separations factor was then

Communications amount, less annual pay-as-you-go (cash) expenses of \$55.4 million, yields an AT&T Communications incremental transition amount of \$414 million. The pay-as-you-go expenses were subtracted from the total because they were presumed to be already in AT&T's PCIs through the normal operation of the price cap formula since the start of price cap regulation.

AT&T Communications' \$414 million incremental expense was then decreased to \$372 million, after taking into account an assumed 10.14% GDP-PI double count offset of \$42 million. Finally, AT&T's \$372 million expense was increased to \$373 million after taking into account the effects of taxes.³⁷

AT&T then allocated the SFAS 112 interstate cost between interstate price capped and noncapped services and among AT&T's price cap baskets on a cost-causative basis, consistent with the Commission's rules.³⁸ Specifically, AT&T utilized December 1993 interstate revenue net of access data to determine the allocation to Baskets 1, 2, and 3 and to noncapped communications services.

(footnote continued from previous page)

applied to the amount booked in Account 32.6728 to arrive at the interstate SFAS 112 amount.

³⁷ See Appendix A, Responses to Issue Nos. 36 and 37.

³⁸ See Price Cap Rules, 47 C.F.R. § 61.44(c)(5) (1994).